Valuation of Accounts Receivables

Overview

Accounts receivable (AR) represent amounts owed to a company by its customers for goods or services sold on credit. However, not all customers will pay, necessitating an allowance for credit losses to estimate uncollectible amounts. The net accounts receivable is presented as:

Accounts Receivable Example
Accounts Receivable: $100,000
Less: Allowance for Credit Losses: ($3,750)
Net Accounts Receivable: $96,250

Two Methods to Estimate Allowance for Credit Losses

There are two primary methods to estimate the allowance for credit losses:

1. **Percentage of Sales Method**
2. **Percentage of Receivables Method**

Similarities Between Methods

Both methods use the **Allowance for Credit Losses** account to track:

1. **Beginning Balance**: Always a credit balance.
2. **Credit Losses Written Off**: Specific receivables deemed uncollectible.
3. **Collection of Previously Written-Off Credit Losses**: Recoveries of amounts previously written off.
4. **Amount Charged to Income Statement**: Recognized as credit loss expense.
5. **Ending Balance**: Always a credit balance.

The journal entry to record credit loss expense under both methods is:
Dr: Credit Loss Expense
Cr: Allowance for Credit Losses

This credits the allowance account because the specific customer who will not pay is unknown.

Percentage of Sales Method

This method estimates credit losses as a percentage of total credit sales for the period. The credit loss expense is calculated directly, and the ending balance in the allowance account is a residual figure.

Steps

1. Calculate credit loss expense as a percentage of total credit sales.
2. Record the credit loss expense, which increases the allowance account.

T-Account for Percentage of Sales Method

Allowance for Credit Losses

Debit	Credit
(2) Credit losses written off	(1) Beginning balance
	(3) Collection of previously written-off credit losses
	(4) Credit loss expense (Calculated from % of credit sales)
	(5) Ending balance (Residual)

Percentage of Receivables Method

This method estimates the allowance based on a percentage of the ending accounts receivable balance. The ending balance in the allowance account is calculated, and the credit loss expense is the residual amount needed to achieve that balance.

Steps

1. Calculate the required ending balance in the allowance account using a percentage of ending accounts receivable or an aging schedule.
2. Determine the credit loss expense as the amount needed to adjust the allowance account to the calculated ending balance.

T-Account for Percentage of Receivables Method

Allowance for Credit Losses

Debit	Credit
(2) Credit losses written off	(1) Beginning balance
	(3) Collection of previously written-off credit losses
	(4) Credit loss expense (Residual)
	(5) Ending balance (Calculated from % of AR or aging schedule)

Using an Aging Table

An **accounts receivable aging report** categorizes receivables by the length of time they have been outstanding to estimate expected credit losses. This is commonly used with the percentage of receivables method to determine the required ending balance in the allowance account.

Example: Anita's Supply Co.

Anita's Supply Co. uses the percentage of receivables method and an aging schedule to estimate credit losses. As of December 31, 20X9, the aging schedule indicates a required ending balance of $43,050 in the allowance for credit losses account.

Before the year-end adjustment, the allowance account has a **debit balance** of $5,000, which is unusual since the allowance typically carries a credit balance. To adjust the account to the required credit balance of $43,050, a credit transaction of $48,050 ($43,050 + $5,000) is needed.

Journal Entry for Adjustment (December 31, 20X9):
Dr: Credit Loss Expense $48,050
Cr: Allowance for Credit Losses $48,050

Summary

- The **percentage of sales method** calculates credit loss expense based on a percentage of credit sales, with the ending allowance balance as a residual.
- The **percentage of receivables method** calculates the required ending allowance balance based on ending receivables or an aging schedule, with the credit loss expense as the residual.
- Both methods ensure the allowance account reflects expected credit losses, maintaining a credit balance.
- An aging table enhances the accuracy of the percentage of receivables method by analyzing the age of receivables to estimate uncollectible amounts.

Factoring Receivables: Using Receivables as an Immediate Source of Cash

Overview

Factoring receivables allows a company to convert accounts receivable into immediate cash by selling them to a third party (factor), rather than waiting for customers to pay. This accelerates cash flows to meet short-term financial needs.

Ways of Factoring Receivables

Receivables can be factored in two ways:

1. **With Recourse**: If the customer fails to pay the receivable when due, the seller of the receivable is obligated to repay the factor.
2. **Without Recourse**: If the customer fails to pay the receivable when due, the seller is not obligated to repay the factor, and the factor bears the risk of non-payment.

Disclosing Factored Receivables

- **With Recourse**: The seller records a **recourse liability** on their books to reflect the potential obligation to repay the factor if the customer does not pay.
- **Without Recourse**: No recourse liability is recorded, as the seller has no further obligation once the receivable is sold.

Summary

Factoring receivables provides a quick way to improve cash flow by selling receivables to a factor. The choice between factoring **with recourse** or **without recourse** determines the seller's liability if the customer fails to pay. Proper disclosure, including recording a recourse liability for with-recourse factoring, ensures accurate financial reporting.